

Forex Medium-Term Outlook

August 29, 2025

Overview of Outlook

In August, USD/JPY lacked a clear sense of direction. There was a sharp drop in the rate early in the month following a significant deterioration in U.S. job data, but the falling trend was not sustained. This only serves to confirm USD resilience even as a U.S. interest rate cut is being priced in. While the impact of Fed personnel changes on rates may be drawing some attention, the Federal Reserve System (FRS) is not so lenient as to allow for sudden policy changes in response to political developments. It would be dangerous to take a significant interest rate cut for granted just because a new administration is coming in. In fact, there is only a moderate pricing in of interest rate cuts for 2H of 2026 onward. If a pro-Trump chair is appointed late this year or early next year, expectations of easing may prevail until the new administration is operational, leading to a weakening of USD and U.S. interest rates. However, there is no guarantee that actual policy operation will be consistent with expectations, and a rate reversal is likely. Incidentally, political intervention in currency and monetary policy also occurred during the Nixon administration. The outcome of that, as history shows, was an undesirable rise in USD and interest rates, which was eventually corrected by the Plaza Accord. The theoretical conclusion is that “monetary easing and a weaker currency in an inflationary environment will naturally lead to further inflation.” In this respect, the Nixon and Trump administrations appear to be facing the same problem. Looking at Japan, household JPY selling has subsided, and the supply and demand environment, as seen in the balance of payments, is improving. These factors may also be contributing to USD/JPY’s top-heaviness.

EUR appreciated slightly in August, directly reflecting the difference between the ECB, which is likely to halt rate cuts, and the Fed, which is likely to resume them. However, various economic statistics suggest that the region’s economic and financial situation is not particularly sound. During the current forecasting period, increased EUR selling cannot be overruled whenever the markets become conscious of the need for the ECB to resume interest rate cuts. That said, there is a sense that EUR will likely be propped up in the long term within the larger trend of “global capital rotation” as part of de-dollarization. Looking at related statistics, it seems possible that, in addition to the rolling back of investments from the eurozone to the U.S., there is also new capital flowing in from major countries to the eurozone. There seems no need, therefore, to assume an EUR crash. Further, on the diplomatic front, European diplomacy to involve the U.S. in NATO and the Ukraine war has been successful so far, and there is a feeling that such factors are also supporting EUR. In addition to economic and financial conditions, geopolitical risks are also important factors in determining the EUR outlook.

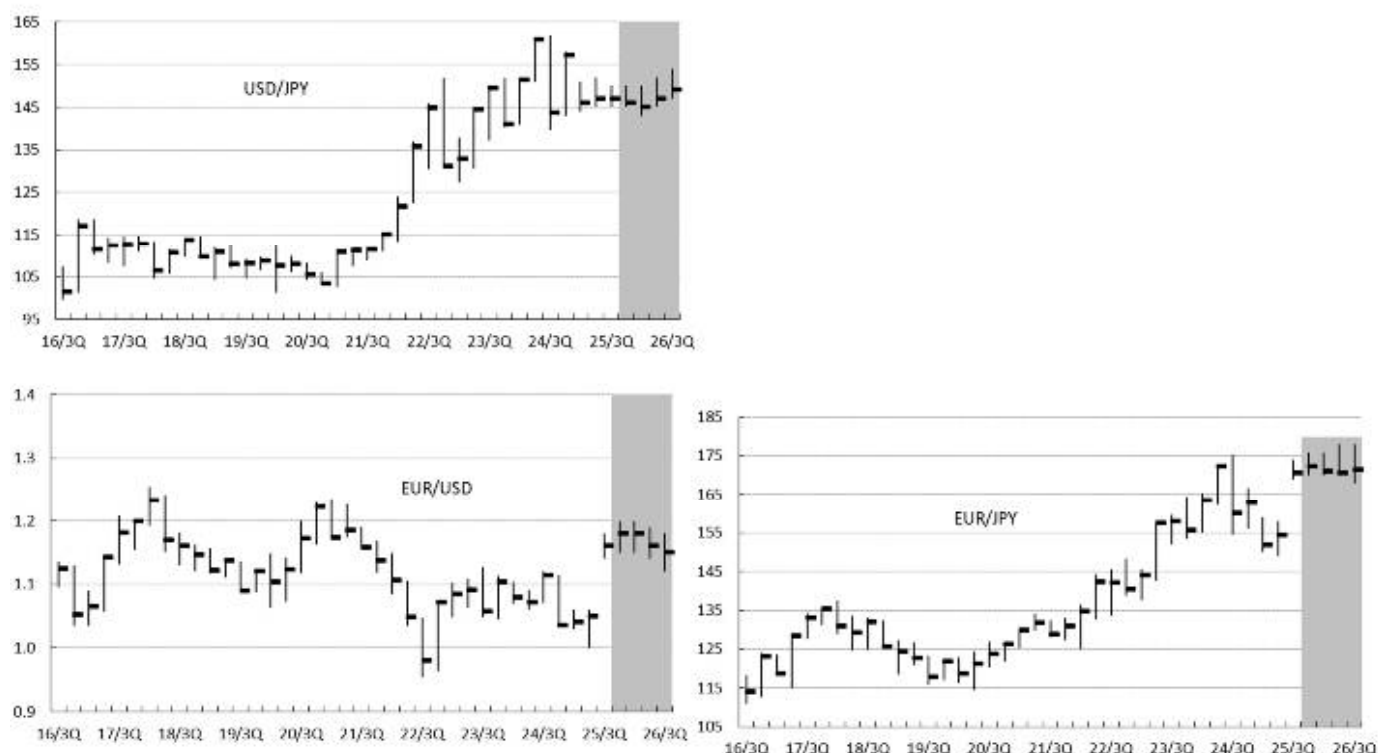
Summary Table of Forecasts

	2025			2026		
	Jan-Aug (Actual)	Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep
USD/JPY	139.89 ~ 158.88 (146.83)	145 ~ 150 (147)	145 ~ 150 (146)	143 ~ 150 (145)	145 ~ 152 (147)	147 ~ 154 (149)
EUR/USD	1.0125 ~ 1.1830 (1.1675)	1.14 ~ 1.18 (1.16)	1.15 ~ 1.20 (1.18)	1.15 ~ 1.20 (1.18)	1.14 ~ 1.19 (1.16)	1.12 ~ 1.18 (1.15)
EUR/JPY	155.63 ~ 173.85 (171.42)	169 ~ 174 (171)	170 ~ 176 (172)	170 ~ 176 (171)	170 ~ 178 (171)	168 ~ 178 (171)

(Notes) 1. Actual results released around 10 am TKY time on 29 August 2025. 2. Source by Bloomberg

3. Forecasts in parentheses are quarter-end levels.

Exchange Rate Trends & Forecasts



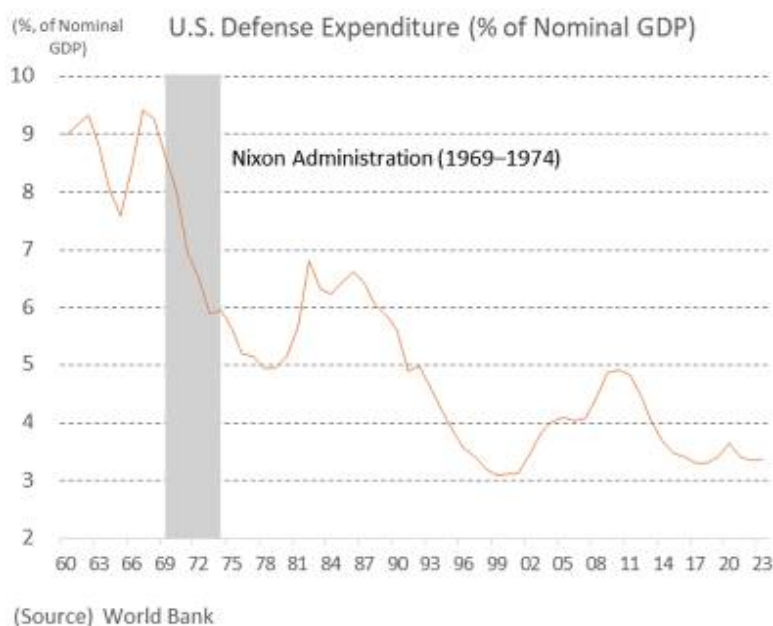
USD/JPY Outlook - Risks Inferred from a Comparison of Nixon and Trump Eras

Forex Markets Now and Going Forward: Reconsidering the Future of USD as Reserve Currency

The U.S. Does Not Intend to Step Down as Hegemon

Since April this year, USD weakening under the second Trump administration has been conspicuously assessed as an undermining of USD's reserve currency status and the dethroning of U.S. as global hegemon. However, it is important to note that the status of the U.S. and USD remained unchanged under the Nixon administration, which implemented similar policies (more on Nixon's policies below). Let us take a look at the impacts/potential impacts of the Nixon and Trump administrations' actions on U.S. hegemony and USD's reserve currency status. A historical perspective is also important when discussing the current situation and outlook going forward.

I believe that the goal of both the Nixon and Trump administrations was/is to reduce the administrative costs of being a hegemon, not to step down as hegemon. The Nixon administration aimed to maintain USD's status as a reserve currency under a floating exchange rate system while maintaining the U.S.' relative security advantage (hegemony) through three policies: the Nixon Doctrine, triangular diplomacy, and the suspension of USD convertibility to gold. Looking specifically at currency policy, the Nixon administration changed the USD-centric international monetary system from one based on a fixed rate convertibility between USD and gold (at USD 35 per ounce of gold) to a floating exchange rate system that ensured monetary policy flexibility and freed the U.S. from the obligation of stockpiling gold reserves. However, without the set of economic measures that came to be known as the "Nixon Shock," it would have been difficult to maintain USD's status as the reserve currency under a floating exchange rate system.



Further, as shown by the figure above, the Nixon Doctrine and triangular diplomacy not just curbed the rise in defense spending but, in fact, led to a downward trend. It can be said that the Nixon administration truly reduced the U.S.' administrative costs as a hegemon. It is also true that the Nixon Shock temporarily caused great damage to the value of USD. The process of reducing the

administrative costs of being a hegemon does result in some shocks to the financial markets. However, this is not synonymous with the “collapse” of USD’s status as the reserve currency.

The relationship between the second Trump administration and USD should be understood in a similar context. The second Trump administration has created a permanent source of revenue in the form of tariffs as an “entrance fee” for doing business in the U.S. market, and reduced the US’s relative defense burden by increasing the military contributions of its allies. Indeed, it is vital for the U.S. to lower its administrative costs as a hegemon at a time like this, when it needs a large amount of funds to confront the new hegemonic power, China. During the Nixon administration, the opponent was the former Soviet Union, and the domestic economy was in a state of exhaustion after the Vietnam War. All in all, it seems more accurate to say that the U.S., rather than stepping down as the reigning hegemon, is attempting to transform itself as a new type of hegemonic power in line with the times.

As with the Nixon Shock, the Trump administration’s attempt to transform into a new type of hegemonic power will come with its own costs. The Trump administration, for its part, also needs to work on dispelling the doubts about USD’s status as a reserve currency which have been swirling since April this year. It will, therefore, be forced to take one step forward and one step back and go about things slowly even if that means being called names such as “TACO” (acronym for “Trump Always Chickens Out”). Taking market conditions into account is part of the gradual process of changing the status quo.

A New Type of Hegemon

So, what exactly is this “new type of hegemon” the Trump administration is aiming to make the U.S.? An interview with Treasury Secretary Scott Bessent published by the Nihon Keizai Shimbun on August 11 provides a clear explanation from a monetary policy perspective. According to Bessent:

- “A strong dollar is not about the price on the screen, which is set by the market, but the relative price against other currencies. The strong dollar policy is to have policies that continue to keep the U.S. dollar the reserve currency. And if we have good economic policies, then the dollar will naturally be strong.”
- “The One Big Beautiful Bill (a tax cuts and spending act) aims to make the United States the most attractive place in the world for foreign capital. For decades, dollars have flowed out due to trade deficits, but now those dollars will come back, invested in a wide range of U.S. financial assets.”
- “What we are promoting is an effort to direct foreign capital not only toward portfolio investments like U.S. Treasuries but also toward direct investment that leads to the return of manufacturing to the United States. To that end, we are pursuing energy dominance, advancing deregulation, and making tax cuts permanent.”

In other words, while U.S. hegemony in the past was characterized by USD flowing out due to trade deficits but returned to the U.S. through securities investments, the strategy going forward will be to switch to a new type of hegemony where USD flowing out due to trade deficits are reduced and then returned to the U.S. through direct investment. To be sure, if capital inflows shifted from securities investment to direct investment, the volume of U.S. exports to the world would recover in the long run, potentially reducing the trade deficit. Further, given that direct investment is a long-term form of capital, it would be less likely to disrupt USD supply and demand. This would also strengthen USD’s status as a reserve currency.

While all this makes logical sense, the real question is whether the administration’s tyrannical negotiation tactics will actually encourage direct investment in the U.S. While various countries have pledged to invest in the U.S., the feasibility of these commitments remains unclear. Regarding purchases of goods from the U.S., as discussed below, the EU, for example, has pledged to more than triple its energy-related purchases, a commitment that seems difficult to realize. One suspects that such promises are merely lip service paid to avoid uncertainty. Further, the Trump administration’s policy mix of interest rate cuts plus tax cuts is expected to overheat domestic demand, which may, in fact, widen the U.S. trade deficit. Bessent’s remarks revealed the true intentions of the administration, namely to transform the U.S. into a new type of hegemonic power and to lower the administrated costs associated with being one, but whether this can be realized is a different matter. It is precisely because this is not properly understood that bond and foreign exchange markets are prone to selling.

USD’s Reserve Currency Status “Shaken” not “Shattered”

To summarize: The aim of both the Nixon and Trump administrations involve maintaining U.S. hegemony while lowering the administrative costs pertaining to maintaining this hegemony. The rumor that the U.S. is attempting to step down from its role as the global hegemon is an exaggeration. As I argue in my recent book, *The Blind Spot of the World Economy*, it is not that the U.S. is the hegemon because USD is the reserve currency, but rather that USD is the reserve currency because the U.S. is the hegemon. At the moment, USD’s status as the reserve currency is faltering because the U.S.’ status as hegemon is weakening.

There are multiple reasons why the U.S. has maintained its hegemony to date, including military might, economic size, cultural and soft power, and abundant resources. While these remain fundamentally true today, military might and economic size are relative, and there is no doubt that the U.S.’ position is threatened by the rise of China. If we take it to be true that USD has been the reserve currency because the U.S. has been the hegemon, then it is easy to understand why any change in the hegemonic status would also threaten USD’s status as the reserve currency. This jolt to USD’s status as reserve currency is directly linked to its weakening since the beginning of the year, but it would be an exaggeration to take the trend to its logical conclusion in predicting the currency’s collapse.

So how should we visualize hegemony? For example, the gap between the U.S. and China in terms of global GDP and trade share has narrowed significantly over the past 20 years (see graph). The same could be said about the two countries' total trade volume and military power. It is understandable that, since hegemony can no longer be guaranteed as it has been so far, the current system cannot be maintained at the same cost.

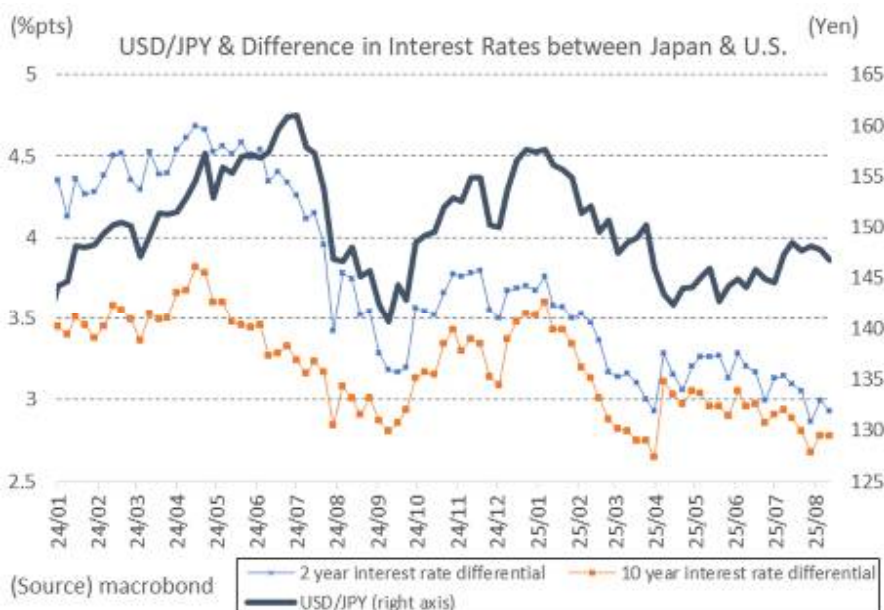
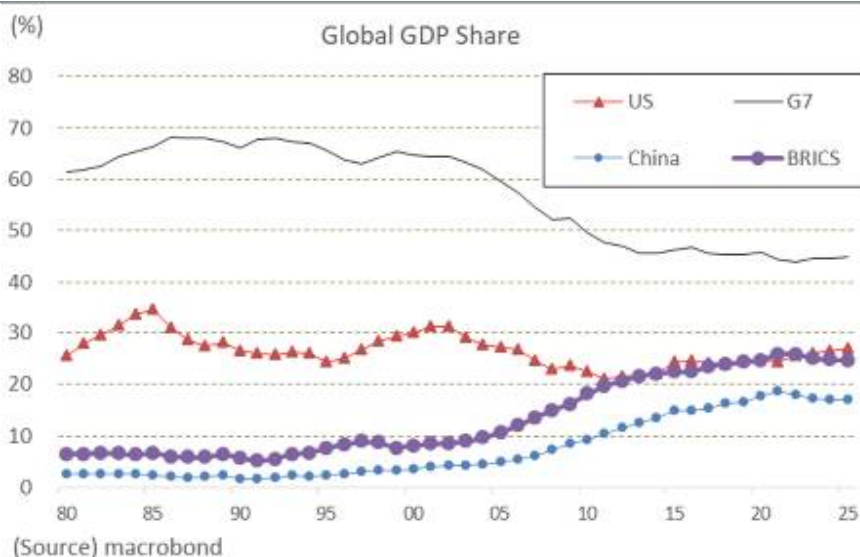
Since "Liberation Day," theories that the U.S. intends to "step down as hegemonic power" have become widespread, and many have suggested that this is leading to capital outflows from the U.S. Given the coexistence of USD weakness and persistently high U.S. long-term interest rates, the possibility of capital outflows cannot be denied. That said, asserting that the U.S. will no longer be a hegemonic power or that USD will no longer be the reserve currency is a leap. It is simply that there may be a change in the scope of responsibilities (job description) of the hegemonic power. Traditionally, the hegemon's responsibilities included providing military and economic public goods to the world, including security (U.S. military might), an international payment system (USD as reserve currency), and free trade (domestic demand as a final consumer market). The result, the Trump administration (and its supporters) argues, is accumulated government debt and a trade deficit, leaving many Americans burdened with the costs. While the Trump administration does not intend to completely halt the provision of these public goods, it hopes to partially suspend them, thereby reducing its administrative costs as a hegemonic power.

However, the fact is that the use of USD rose in proportion to the extent of public goods provided by the U.S. If the provision of these goods is curtailed, USD's use will inevitably dwindle. A reserve currency is, by definition, a currency with overwhelmingly high usage volume. If its use declines, naturally its reserve currency status will also fade. Since April this year, the U.S. has repeatedly communicated its intent to curtail the provision of public goods, so a certain degree of USD depreciation may be unavoidable. However, this does not mean that USD's status as the reserve currency has collapsed. It would be more appropriate to say that USD is experiencing a jolt, which alone is enough to shake up the forex markets. As a result of this jolt, EUR, RMB, other currencies, and gold have relatively appreciated.

The unipolar system centering on USD is only 50 years old, counting from the mid-1970s, after the Nixon Shock, to the present day. From 1944 to the Nixon Shock, a bipolar system was in place, with GBP and USD as the two poles. Going forward, a multipolar system, including EUR and RMB in addition to USD is a possibility. In fact, I have discussed the diversification of global forex reserve management many times in this report over the past decade or so.

Assessing JPY Is a Separate Issue

As I have argued in the past, the recent jolt to USD does not necessarily mean that JPY, which has already suffered a significant depreciation, will recover its previous value. Since April, JPY interest rates have been steadily rising, and the interest rate differential between Japan and the U.S. has clearly narrowed. However, the net outcome of all this has still been JPY depreciation (see graph). While on the one hand there are concerns of high U.S. interest rates as a result of de-dollarization, there is also growing concern in Japan about rising JPY interest rates driven by doubts over the sustainability of the country's massive government debt. In such a situation, it makes no sense to evaluate the strength or weakness of two currencies based on their relative interest rates, yet this simplistic explanation continues to be readily employed. However, the reality cannot be understood based on such simplistic perspective.



U.S. Monetary Policy Now and Going Forward – No Sudden Turnaround Expected from a New Administration

Confirmation of Rate Cut Path

In Fed Chair Jerome Powell's speech at the much-anticipated Jackson Hole Economic Symposium, markets focused on his remarks that the Fed would "proceed carefully" with rate cuts, leading to a decline in U.S. interest rates and a sharp rise in U.S. stock prices. However, a closer examination reveals that Powell's main focus in his speech was not economic or financial assessment (Current Economic Conditions and Near-Term Outlook) but rather a revision of monetary policy strategy (Statement on Longer-Run Goals and Monetary Policy Strategy), which took up over half to nearly 60% of the speech. Given that the Jackson Hole Economic Symposium is unequivocally known to be a gathering of central bank governors, policymakers, academics, and economists from around the world to discuss important long-term issues, the strategy revision was the more important topic. It is, in fact, unreasonable to expect it to provide hints about the next monetary policy move, even though this has been the case in recent years. The practice of hinting at the next monetary policy move was started by former Fed Chair Ben Bernanke, who caused quite a stir by hinting in his speech in August 2010 at the possibility of a second round of quantitative easing (QE2). At the time, the wounds of the Lehman Shock and the European debt crisis had not yet healed, so perhaps it was unavoidable as part of an emergency response, but given the subsequent impact, it seems a rather sinful act in retrospect.

To return to Powell's speech, and review his comments related to economic and financial situation assessment, he stated that "monetary policy is not on a preset course" and emphasized that future decisions would be made based on data. In this respect, there is no indication of any change in Powell's stance. That said, while he did not go as far as in his 2024 Jackson Hole speech, when he announced the beginning of a phase of interest rate cuts, his clear statement regarding the rapid slowdown in employment and wage growth (suggesting that low unemployment rate was an illusion caused by immigration restrictions) and on the impact of tariffs on inflation being temporary were notable. Regarding the latter, which has been seen as an obstacle in the path of rate cuts, Powell stated, "A reasonable base case is that the effects will be relatively short-lived—a one-time shift in the price level," indicating that the impact of tariffs was not a problem in the base-case scenario. Given the above, it seems possible that there will be a straightforward rate cut in response to a downturn in economic and financial conditions, including employment. Of course, if real wages continue to stagnate, there is the risk that workers will continue to demand high nominal wage growth, and Powell mentioned "adverse wage-price dynamics" as something to be wary of, while also pointing out that this outcome did not seem likely. Overall, it would not be unreasonable to read Powell's speech as suggesting a rate cut as the Fed's next move. Focusing on the short term, if Chairman Stephen Miran of the Council of Economic Advisers (CEA) is able to take up his position in the Federal Reserve Board on time for the September FOMC meeting, three votes in favor of a rate cut are assured, with governors Michelle Bowman and Christopher Waller providing the other two. If the status quo is maintained despite this, that would clearly indicate a divide within the FOMC that will continue beyond the October meeting.

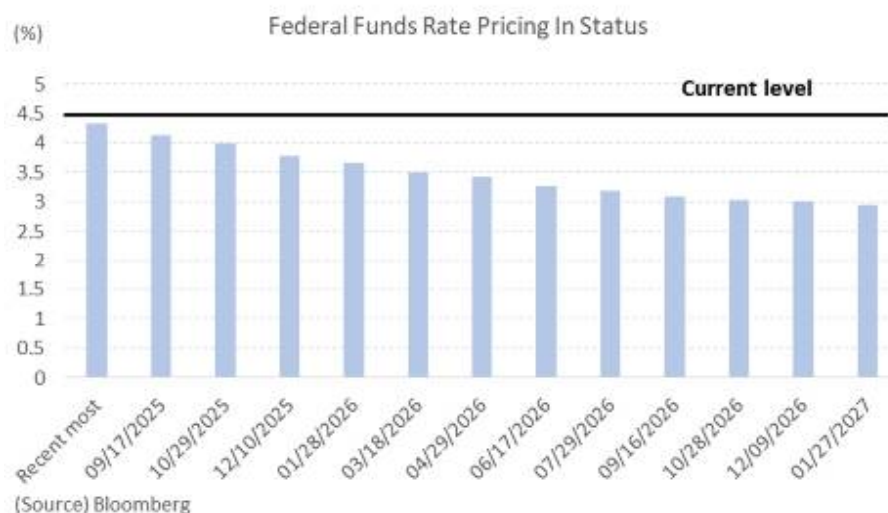
Interpreting the Strategy Revision

As mentioned above, Powell's recent speech focused primarily on revising the Fed's monetary policy strategy. The current strategy is Flexible Average Inflation Targeting (FAIT), as announced at the 2020 Jackson Hole Speech. In the pre-pandemic world, policy rates easily reached the Effective Lower Bound (ELB), so the prevailing thought was that there was no need to rush to tighten monetary policy even if inflation slightly exceeded +2%. At the same time, this also meant that a reasonable period of monetary easing was acceptable as long as inflation remained below +2%. In essence, FAIT "seeks to achieve inflation that averages 2 percent over time," and given the significant downward pressure on inflation in reality, FAIT acknowledges asymmetric policy operations (i.e., policy operations with a strong easing bias) around +2%. However, the intended duration of "over time" has remained unclear to the end.

In hindsight, the Powell administration's biggest mistake has been its continued assessment of post-pandemic inflation as transitory, based on the thinking behind FAIT. In his speech, Powell noted that while policy rates are significantly higher than before, the neutral interest rate has also risen, taking into account productivity, demographic trends, and fiscal policy. This may have been intended to dismiss the need for a significant rate cut. The new strategy explicitly recommends a shift away from excessive concern about the ELB, instead pursuing a "dual mandate" of maximum employment and price stability, taking into account the overall economic situation. In essence, this represents a move away from FAIT and a return to a more conventional approach to inflation targeting. Market participants should expect symmetric policy operation around the +2% target. When FAIT was announced, it was widely viewed as dovish in financial markets. The current strategy revision represents a reversal of that strategy, so it is unsurprisingly perceived as hawkish, but it is not something the financial markets are all that interested in.

2H of 2026 Onward is Key

When it comes to the Fed's policymaking, the real issue is not the actions of the Powell administration, which will become a "lame duck" in the coming months, but rather how the incoming administration, which sympathizes with the wishes of Trump, will conduct policy operations post June 2026. According to reports, Trump wants interest rates cut to the low 1% level, while Treasury Secretary Scott Bessent would also like to see rates brought down to 2.75-3.00%. Bringing the rate down to 1.25% from the current level (4.25-4.50%) would require 12 rate cuts (25bp x 12 = -300bp), but even bringing it down to 2.75% would require six rate cuts (25bp x 6 = -150bp). There are six FOMC meetings remaining in Powell's term. If



things go as per what the markets have factored in, there will be just under four rate cuts during this term (two this year and just under two by the April meeting next year) and two more by the December 2026 meeting after the new administration takes over (see graph, priced in immediately following the Jackson Hole meeting).

In other words, the markets have factored in only two rate cuts in 2026 (over the course of five meetings) after the new administration takes office. Is this really all the market expects to see from a "pro-Trump Fed"? While the markets do factor in the policy rate suggested by Bessent (2.75%) by the end of 2026, this is still a long way from Trump's target. If the new administration, launched with much fanfare, only manages to cut rates twice in the first six months, is that not "more moderate than expected" given all the abusive rhetoric against Powell? As mentioned earlier, excessively dovish expectations of a pro-Trump Fed may encourage USD depreciation and lower U.S. interest rates until May 2026, when the Fed's new leadership takes over. However, a rebound should be expected starting from 2H of 2026, reflecting more realistic policy operations.

Miran and Fed Appointments

As Powell's term draws to a close, Fed appointments and the resulting policy implications are likely to attract increasing attention. As mentioned, it was widely reported in August that Miran will temporarily fill a vacancy left by Fed Governor Adriana Kugler, who herself replaced Lael Brainard. The appointment of Miran is temporary, scheduled to last until the end of January 2026, when Kugler's term would have expired. Miran will take up his seat on the Board of Governors after the Senate confirmation process resumes in September. However, it remains to be seen whether his confirmation at the Senate Banking Committee hearing and full Senate vote will take place in time for the September 16-17 FOMC meeting. Miran's first FOMC meeting may well be the October 28-29 one.

However, it is questionable whether this news is as significant as the headlines suggest. Miran has been known as a theoretical supporter of a weaker USD since around the time of the second Trump administration's inauguration. His support for rate cuts does not come as a surprise, and the Senate hearing is likely to take into account the fact that Miran would support rate cuts as a governor. Since Miran will only be attending four FOMC meetings (three this year and one in the new year), it will be easy for him to maintain consistency between words and actions (he has not much need to change his judgment depending on economic and financial conditions). This poses the risk that he could continue to promote a -50bp rather than -25bp rate cut, which would create the impression of a Trump-influenced Fed administration, potentially triggering a temporary acceleration in the decline of U.S. interest rates and USD.

Ultimately Fed Appointments Make no Difference

I view the speculation-driven market surrounding Fed appointments as merely a short-term phenomenon. Irrespective of the composition of the Fed's leadership, policy operations incompatible with real economic and financial conditions are unsustainable. Let us assume that the next Fed administration decides to lower the policy rate, as Trump desires (which, as we will discuss later, is not easy given the FOMC's system). There is no guarantee that this will trigger a correlated decline in U.S. interest rates and USD as Trump expects. A steady U.S. interest rate and USD decline requires a steady deterioration in the U.S. economic and financial conditions. If the U.S. labor market continues to deteriorate, as it did in July, and is accompanied by sluggish GDP and falling inflation rates, that could lead to the assessment that the Powell administration was too late to act, and that the new administration's policy operations are appropriate and sustainable. Conversely, if the new administration's rate cuts coincide with rising inflation rates, no deterioration in job data, and solid GDP growth, the assessment will be that the Powell administration was right after all, while the new administration's policy operations disregarding central bank independence are a failure.

In short, policy operations are always judged by their consistency with current economic and financial indicators. Therefore, it is not crucial to deliberate on rate trends based on the composition of the Fed's executive team, including the chair. If it turns out the Powell administration was right and the new administration's policy operation is a failure, U.S. interest rates and USD could accelerate even more than before the rate cuts began. If Trump really insists on interfering with monetary policy operations, this could become a medium- to long-term risk of concern. In fact, as New York Fed President John Williams and others have suggested, inflation over the next year may remain higher than

expected, partly due to the impact of tariffs. With economic and financial conditions not justifying successive rate cuts, political machinations are unlikely to pan out.

Rate Cuts by New Administration Not Guaranteed

Returning to the present, if job data remains as dismal as it has been since May, we may see a series of rate cuts initiated by the Powell administration itself, as suggested at the Jackson Hole Economic Symposium, and financial markets have already priced this in. However, if this happens, it will lessen the need for interest rate cuts from 2H of 2026, after the start of the new administration, even more. In fact, as noted above, only two rate cuts are factored in for the rest of 2026 from June onward, when the new administration becomes operational.

This presumably reflects the awareness that the Federal Reserve System (FRS) is not so lenient as to allow for rapid policy changes. As is well known, the FOMC consists of 12 members: seven governors (including the chairman) and five regional federal reserve bank presidents. While governors require presidential mandates and congressional approval, regional bank presidents are appointed through a two-tiered system in which regional boards of governors take the lead in nominating members who are subsequently approved by the Federal Reserve Board. The president has no direct influence over the appointment of regional bank presidents, which is why the system is designed to prevent sudden changes in monetary policy due to a change in administration. The Fed's regional bank presidents are set up to be uninfluenced by politics, precisely in preparation for situations like the current one.

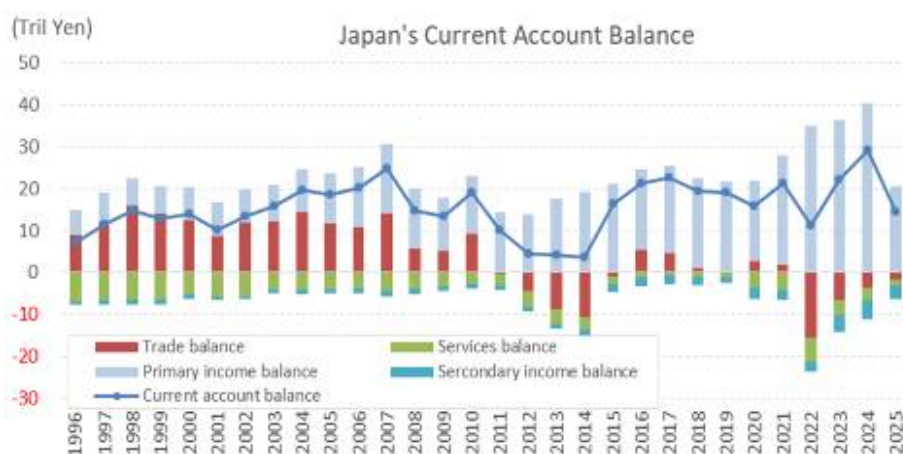
In short, even with a new administration, there is no reason to take major interest rate cuts for granted. A pro-Trump chair could be installed between the end of the year and early 2026, potentially leading to a speculative decline in USD and U.S. interest rates until the first meeting of the new administration (June 16-17, 2026). However, in the run up to the midterm elections starting mid-2026, U.S. economic and financial conditions must ideally remain resilient enough to avoid the need for a rate cut. Rates driven by Fed personnel changes are likely to have a short shelf life, lasting only until the start of the new administration.

JPY Supply and Demand – Improving Supply and Demand Balance

1H of 2025 Posted Largest Ever Statistical Surplus

USD/JPY continues to fluctuate in the 145-150 range. Amid turbulence in various areas, including the economy, finance, and security, there is less time to discuss Japan-specific factors. However, Japan's balance of payments statistics through June 2025 have become available, and it is worth taking this opportunity to examine the JPY supply and demand climate as of 1H of 2025. To provide a summary of the statistical results, the current account balance for 1H of 2025 was +JPY 14.5989 trillion, the second-largest surplus on a half-year basis and the largest ever surplus posted for 1H. Incidentally, the largest surplus ever recorded on a

half-year basis was for 2H of 2024 (+JPY 15.9857 trillion), which makes it possible to view Japan's current account surplus for the most recent one-year period as the largest in history (at +JPY 30.5845 trillion). Needless to say, this statistical surplus was supported by a primary income surplus, with the recent +JPY 20.7668 trillion being the largest surplus ever recorded on a half-year basis. However, as I have argued repeatedly in previous reports, much of this surplus is suspected to be reinvested overseas, and does not directly translate into JPY buying. Meanwhile, the trade and services balance, which accounts for a large proportion of outright transactions in the forex market, remains in deficit, even though the deficit is steadily shrinking (-JPY 3.1368 trillion). Regarding the services balance, the travel balance for 1H of 2025 posted a surplus of +JPY 3.6065 trillion, again the strongest ever surplus on a half-year basis. The digital balance, on the other hand, posted a deficit of -JPY 3.481 trillion, almost cancelling out the travel surplus. Structurally speaking, therefore, there is no change in the fact that Japan's strongest external economic sector, the travel balance, barely offsets the digital deficit.

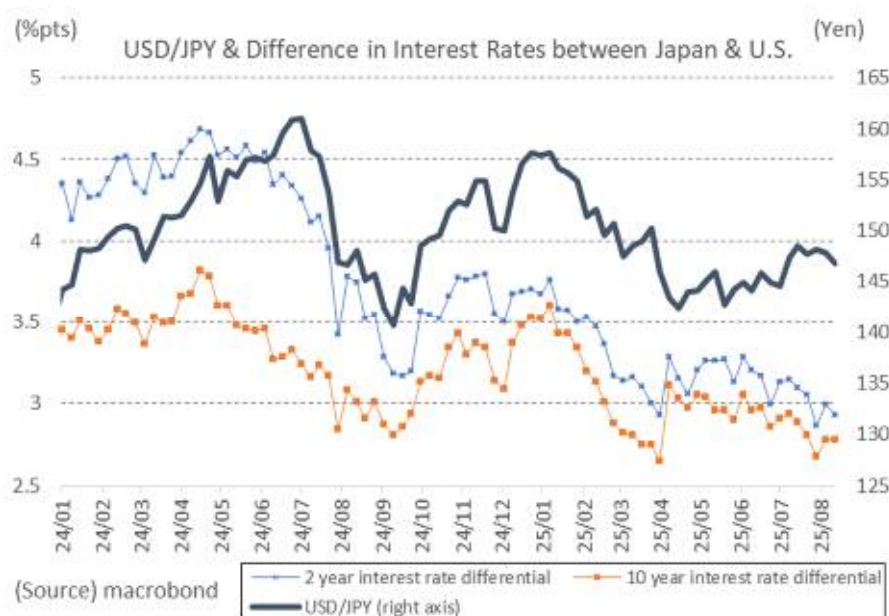
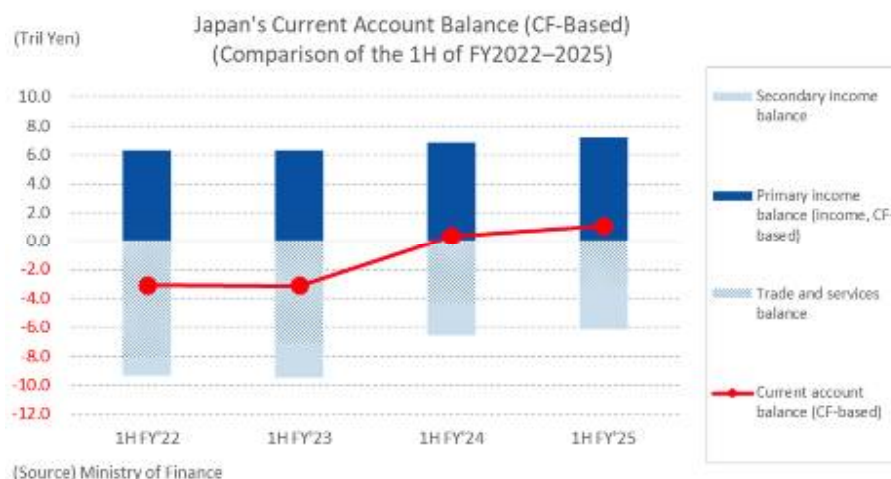


(Source) Ministry of Finance Figures for 2025 are totals for Jan-Jun.

Improvement Evident Also on Cash-Flow Basis

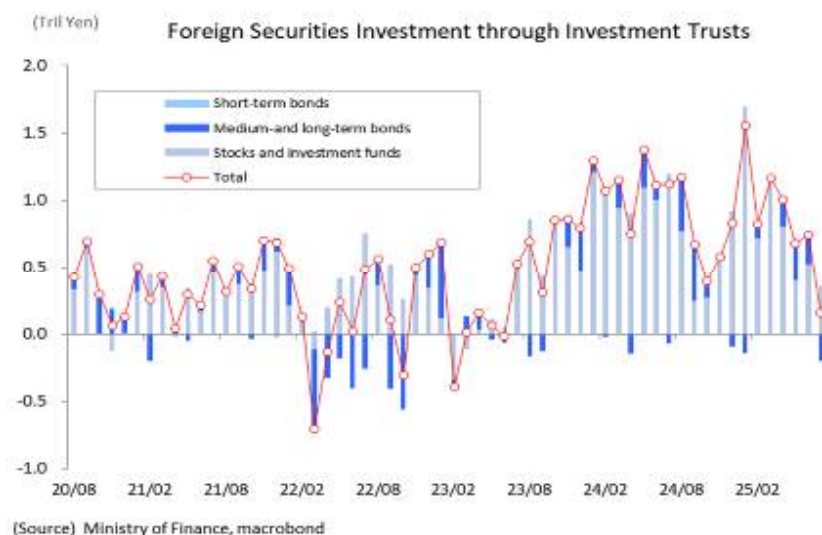
Let us move to an evaluation of the current account balance on an actual cash flow (CF) basis. Assuming that reinvested earnings and securities investment income from the primary income balance are not converted into JPY, the CF-based current account balance for 1H of 2025 is a small surplus of +JPY 1.0562 trillion. This reveals a clear improvement in the JPY supply and demand balance from 1H of 2023, when the CF-based current account balance was +JPY 350 billion, not to mention 1H of 2022 and 2023, when it was -JPY 3 trillion (in deficit). This is partly due to the fact that the statistical primary income surplus is growing, resulting in a larger portion being repatriated into the domestic market (contributing to the CF-based surplus). However, the main reason is a clear improvement in the goods and services deficit as a result of shrinking deficits in both trade and services. The main cause behind this, however, is the fall in resource prices, particularly crude oil prices. As there is no guarantee that resource prices will continue to fall beyond the current level, this trend of the shrinking goods and services deficit may be nearing its end.

In any event, USD/JPY has not returned to the high it posted earlier this year (at nearly 160 yen to the dollar). This is due to (1) the strong likelihood of the Fed resuming interest rate cuts, (2) the strong likelihood of the BOJ continuing to raise interest rates, and (3) the improving JPY supply and demand climate. Moreover, in the financial balance, there are signs of a slowdown in household JPY selling, which has been attracting attention since last year for contributing to JPY selling pressure since the launch of the New NISA scheme (details below). On the other hand, Japan's fiscal risk, which has been a contentious issue off and on since April, may be viewed by foreign market participants as a reason to sell JPY. In fact, USD/JPY is no longer strongly correlated with the U.S.-Japan interest rate differential. This may be because rising JPY interest rates are not necessarily interpreted as a buying factor for JPY any more (see graph). It may, therefore, be more useful to look into underlying factors rather than focusing superficially on the widening or narrowing of the interest rate differential.



Smallest Net Acquisition Since New NISA Launch

Looking at the July International Transactions in Securities (based on reports from designated major investors), foreign securities investment via investment trust management companies (hereinafter "investment trusts"), which have been attracting attention as a proxy for "household JPY selling," posted a net acquisition of +JPY 157.7 billion, the smallest net acquisition since March 2023. This is also the smallest since the launch of New NISA in January 2024. As the figure to the right shows, it is clear that investment appetite has weakened since the chaos caused by "Liberation Day" in April, and a net disposition is in sight for the first time since June 2023. Looking at the breakdown by product, equity and



investment fund shares posted +JPY 333.5 billion, the smallest since October last year, while long-term debt securities posted -JPY 198.9 billion, the first sell-off in six months, since January. The three-month average of equity and investment fund shares has been steadily declining since April (+JPY 876.5 billion → +JPY 770 billion → +JPY 573.1 billion → +JPY 417.2 billion), suggesting a slowing down in overseas stock investment, primarily in U.S. stocks, which has been taking place since January 2024.

Is There an “Overseas → Domestic” Rotation?

As mentioned in last month’s report, so long as the Japan-U.S. tariff negotiations were shrouded in uncertainty, a “hold for now” sentiment may have been prevailing in the markets. This uncertainty, however, cleared following the agreement reached between the two countries on July 24. Going by the Nikkei Stock Average hitting a record high on August 11, one suspects investor sentiment improved from late July onward, and that this will result in a recovery in household JPY selling for August. If such a recovery fails to materialize, it may be necessary to acknowledge that JPY selling pressure has let up partially.

However, it is also possible that domestic investor sentiment is improving while overseas investors are holding back. As mentioned above, the Nikkei Stock Average has been performing strongly, hitting a record high in August. While there are many possible explanations for this, if one takes a long view, stock prices may simply be rising as a natural consequence of inflation. As wages and prices rise, it is only natural that assets such as stocks, real estate, and currency will also nominally appreciate. The possibility of a swing back from the bias toward foreign currency-denominated assets as seen so far, to JPY-denominated assets cannot be ruled out (it may already be occurring).

Given Japan’s inflation rate, which has remained higher than that of Europe and the U.S. in recent years, a rotation from overseas to domestic markets would not be surprising. Also, considering the long period of disinflation in Japan, there may still be room for inflation to catch up. However, according to data from Japanese stock exchanges, individual investors have been net sellers since March through July of this year, so the rotation hypothesis does not appear to be valid at this time. However, if USD/JPY remains below its highest level since last year and the Nikkei Stock Average continues to rise, it is possible that more investors will become aware of the “risk of not holding” Japanese stocks. For now, a fair assessment of the situation seems possible by evaluating overseas securities investments via investment trusts alongside trade in domestic stocks.

Risks to My Main Scenario – Concerns that Trump Policies Could Cause Excessive USD Appreciation

Comparing President Trump with President Nixon

I have been receiving a growing number of inquiries about the Trump administration’s involvement in Fed personnel-related matters and how that situation might affect financial market trends. Replacing just one of the 12 Federal Open Market Committee (FOMC) members (including the chairman, vice chairman, five other governors and five regional Fed bank presidents) will not be sufficient to cause a sharp policy stance change, however, so the Trump administration would not be able to make the Fed adopt a more-dovish stance by means of small-scale personnel measures. The possibility of Fed personnel changes causing Fed policy adjustments will become a relatively important issue during the period from when the new Fed chairman candidate is announced until he or she is actually inaugurated and begins managing policy (probably in May 2026), and it appears most likely that the new Fed chairman candidate will be announced in late 2025 or early 2026, although there are rumors that President Trump might name a candidate much sooner than that.

From a historical perspective, many people have compared the second Trump administration’s assertive actions (including its monetary policy interventions) to those seen during Richard Nixon’s two presidential terms (1969-1974). Though they operated in quite different historical contexts, the two presidents have much in common, such as a protectionist orientation in trade policy, a preference for USD weakness and low interest rates in currency and monetary policy, and demands that allies share their fair share of international security burdens. Overall, President Trump and Nixon are similar in that they openly uphold the value of “putting American interests above the international order” (see table). In light of that, I believe an understanding of the Nixon administration’s policy management processes and outcomes (particularly regarding economic policies) will help better understand U.S. economic and financial trends during the Trump administration:

Similarities between the Nixon and Trump Eras

Issues	Nixon (1969-1974)	Trump (2025-present)	Similarity
Trade policies	10% import surcharge	Reciprocal tariff policy (flat 10%, variable surcharge rate)	Protectionist orientation
Currency policies	Suspension of USD-gold convertibility	Mar-a-Lago Agreement's weaker USD orientation	Preference for USD weakening
Financial policies	Pressure on Fed Chairman Burns	Pressure on Fed Chairman Powell	Low-interest-rate policy
Foreign policies	[Nixon Doctrine] Require allies to increase their defense burden and reduce direct U.S. military intervention	[America First] Demand increased defense spending from NATO allies, Japan, and South Korea	Requirement that allies shoulder their fair share of security costs
Objectives	End the Bretton Woods system	Desire for Bretton Woods 2.0	Lowering the cost of hegemonic power
Risks	Stagflation	Stagflation	Shared policy of monetary easing amid inflation

(Source) Compiled by author

Performance of the Nixon Administration

The Nixon administration implemented a wide range of policies, which can most easily be evaluated with respect to the administration's two main objectives: (1) "restoring the United States' international standing" (weakened by the Vietnam War) and (2) "stabilizing the domestic economy".

Regarding objective (1), Nixon's expansion of the United States' cold war period international relations scope is often cited as a diplomatic success. The Nixon administration issued a statement in 1971 stating that it would seek to improve U.S. relations with China. In February 1972, Nixon became the first U.S. president to visit China, resulting in an improvement in U.S.-China relations. Leveraging those improved relations to place additional pressure on the Soviet Union, the United States was able to finalize the Strategic Arms Limitation Treaty (SALT I) with the Soviet Union in May 1972. This marked the first time that the Cold War's nuclear arms race had been limited as well as the starting point for efforts to promote progressive détente (easing of tensions) between the United States and the Soviet Union. The Nixon administration's diplomatic strategy of putting pressure on the Soviet Union through U.S.-China rapprochement and putting pressure on China through U.S.-Soviet détente is described in history textbooks as a classic case of successful "triangular diplomacy". The "triangular diplomacy" was accompanied by U.S. demands that its allies shoulder their fair share of security burdens, however, and while this reinforced the United States' diplomatic negotiating power in the short term, some say that it undermined the credibility of U.S. security commitments over the long term.

The Nixon administration earned a certain degree of positive feedback for its performance regarding objective (1), but suffered harsh criticism for its performance regarding objective (2), "stabilizing the domestic economy". From the perspective of financial markets, mention of the Nixon administration first and foremost brings to mind the August 15, 1971, announcement that USD-gold convertibility would be suspended – the so-called Nixon Shock. That marked the end of the international financial order (the so-called Bretton Woods system) that had been based on a USD-gold standard (the premise that USD could be converted into gold at a specified rate) and had been sustained since the end of World War II. Why did the United States suspend USD-gold convertibility? The immediate cause was the fact that, since the late 1960s, the United States had been recording twin deficits (budget and current account deficits) as a result of the Vietnam War and large-scale welfare programs, resulted in an excessive supply of USD and a shortage of gold reserves designed to back that USD. It became clearly impossible to allay fears of sharp USD depreciation without suspending USD-gold convertibility.

In particular, from the late 1960s through the early 1970s, the U.S. economy was suffering from typical stagflation symptoms, with both inflation and unemployment rates remaining high (see graph). The Nixon administration hoped that severing the USD-gold convertibility obligation would broaden the Fed's leeway for monetary easing and that the consequential weakening of USD would strengthen U.S. export competitiveness and support the domestic economy (lower unemployment). However, monetary easing policies and the USD depreciation trend naturally had the effect of further boosting inflation rates. To alleviate this, in August 1971, the Nixon administration enacted the Economic Stabilization Act, which suspended USD-gold convertibility and also granted the President temporary powers to impose price and wage controls. Those presidential powers were initially used to freeze all price increases, salary increases, and rent hikes for 90 days, and similar caps on various increases were



(Source) macrobond

imposed subsequently. These measures helped to contain inflation expectations in the short term and inflation rates actually fell, but as the graph shows, the drop in inflation rates did not become a sustainable trend. At the time inflation was being promoted in the United States by such sustained structural factors as fiscal deficits, wage inflation, and surging international crude oil prices, and the government's price and wage controls were merely a stopgap measure with temporary efficacy. After the controls were lifted, inflation rates soared to higher levels than previously and, the damage suffered by market-based price discovery functions caused prices to fluctuate wildly. The confluence of these factors combined with the first oil shock to confront the United States with even-more-dire stagflationary trends.

It is worth noting that, at the same time as it suspended USD-gold convertibility, the Nixon administration also imposed a 10% import surcharge. This move was intended to promote the appreciation of currencies of countries recording trade surpluses with the United States, with the goal of thereby reducing U.S. trade deficits. Just four months after the USD-gold convertibility suspension and import surcharge were announced (December 1971), the United States arranged the Smithsonian Accord, which provided for the significant appreciation against USD of all major currencies. (JPY was revalued upward by 16.88%.) This is reminiscent of Trump administration statements made this past April and May suggesting that countries not desiring additional tariffs should work to promote upward revaluations of their currencies.

From a historical perspective, the Nixon administration was unusual in that it was a Republican administration that strongly valued market functions and yet it still resorted to the use of protectionism and price and wage controls. Nixon was reelected president in a landslide victory in 1972, and his overwhelming popularity at that time is said to have reflected his diplomatic successes (such as the normalization of U.S.-China relations and promotion of détente with the Soviet Union) as well as his apparent ability to suppress stagflation and realize a (temporary) improvement in ordinary citizens' purchasing power during the 1971-1972 period.

Excessive Inflation, Rising Interest Rates, and USD Appreciation

As mentioned, although stagflation symptoms were restrained until Nixon's reelection, the initial effectiveness of his monetary and financial policies was short-lived, and those policies ultimately proved to be at odds with the economic and financial situation. The graph above shows that both inflation and unemployment rates were clearly restrained from 1970 to 1972, but after 1973, when Nixon's second administration began, both began to rise again. The impact of the first oil crisis caused the CPI growth rate to reach double-digit levels. The renewed rise of CPI growth in the 1976-1979 period reflected the second oil crisis, which was triggered by the Iranian Revolution and the halt of crude oil exports from Iran. In August 1979, Paul Volcker became Fed chairman and devoted himself to containing inflation. He raised the federal funds rate to nearly 20% by March 1980, double the August 1979 rate. It is well known that the continuous rise of interest rates during Volcker's term as Fed chairman led to a historic surge of excessive USD appreciation that required the Plaza Accord of 1985 to offset.

When one considers present day developments in light of those historical events, there are clearly reasons for concern. As mentioned above, one of the Nixon administration's mistakes was not recognizing that promoting monetary easing and currency weakening amid already-inflationary conditions will naturally lead to additional inflation, yet this is exactly what the Trump administration is currently trying to do. Monetary policy management that is out of sync with economic and financial conditions will ultimately prove to be mistaken. If the Trump administration ignores this as it seeks to intervene in monetary policy, it can be expected to generate undesirable levels of inflation that require interest rate hikes and thereby cause USD appreciation. The second Trump administration is forcing other countries into trade deals that favor the United States (primarily through reciprocal tariffs) and it is demanding in the context of trade deals that the other countries also shoulder their fair share of security costs. Domestically, the second Trump administration is intent on forcing the Fed chairman to ease monetary policy. The actions of the second Nixon and Trump administrations are quite similar, and it is likely that they will generate similar outcomes. Regarding presidential intervention in monetary policy, President Nixon's coercion of Fed Chairman Arthur Burns into easing monetary policy was revealed after the fact in the tapes released during the Watergate scandal as well as in Chairman Burns' memoirs. Similarly, President Trump is now openly threatening Chairman Powell, and the erosion of the central bank's independence is more blatant than it was during the Nixon era.

As mentioned, even if expectations of easing under the new Fed leadership do depress U.S. interest rates and weaken USD in the first half of 2026, it is unclear whether those trends will continue in the second half of 2026 and subsequently. After his installation of a new Fed chairman, one can only hope that President Trump will not become frustrated to perceive a gap between his plans and actual developments and that President Trump will not then express his anger by punishing other countries by such means as tariff policies. For example, if interest rate cuts do not progress as expected and the strength of USD does not decrease, it is not impossible that President Trump might unreasonably claim that Japan is intentionally weakening its currency or that the United States must further elevate its tariff rates to offset the weakness of JPY.

Future of U.S. Hegemony

There has been a considerable increase in criticism of the Trump administration since April 2 (declared by President Trump to be "Liberation Day", from which time he would launch trade policies designed to liberate the United States from 'unfair' trade relationships), with some claiming that Trump's policies are undermining USD's reserve currency status or that Trump is seeking to discontinue the United States' global hegemony. However, the United States' hegemonic power has not actually diminished since the time of the Nixon administration, which implemented policies similar to those of the Trump administration. While many financial market players are prone to making exaggerated predictions of a dramatic collapse of U.S. hegemony, the reality is that the United States' simply has the goal of preserving its hegemonic status while reducing the management costs of being a hegemonic power. It should be understood that all rumors about the United States voluntarily relinquishing its hegemonic power are greatly

exaggerated. As mentioned, it may become more difficult to maintain a unipolar USD-centered international financial system going forward, but it remains highly likely that USD will be the world's most powerful currency. Realistically, it seems reasonable to anticipate that the reserve currency system will gradually become somewhat multipolar, with USD coexisting with RMB and EUR, yet it would be highly risky to place too much faith in rumors about the potential for dramatic changes to USD's status and power.

EUR Outlook – Halt to ECB Interest Rate Cuts a Given?

EUR Area Trade and Diplomatic Relations – Wise Decision or Craven Compromise?

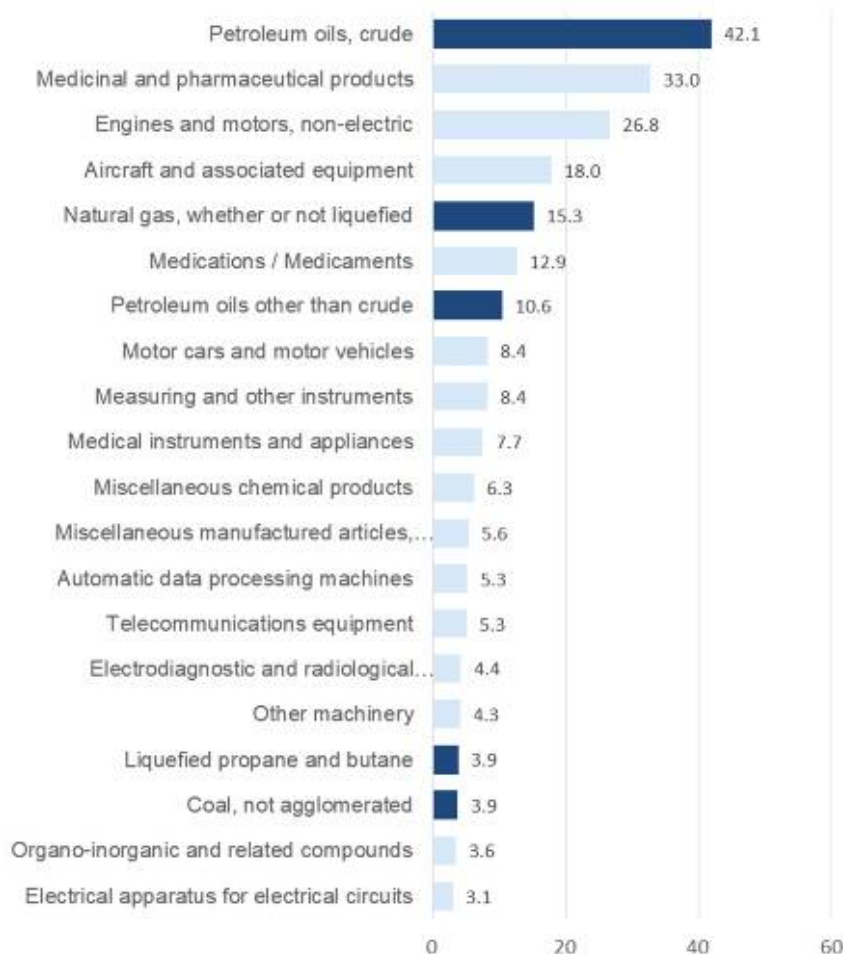
U.S.-EU Agreement Evokes Signs of Discontent in Europe

A broad agreement stemming from U.S.-EU tariff negotiations was announced on July 27, but conflicting information about the timing and conditions of the agreement's implementation has emerged during August. There remain fundamental questions about how to describe or characterize the agreement, and I would like to offer my own thoughts on this based on generally available information. First, the agreement calls for a flat 15% tariff rate to be applied to the majority of products exported from the EU to the United States, including such high-profile products as automobiles, semiconductors, and pharmaceuticals. The additional tariff rates, which had previously been raised to 30%, have now been halved, and headlines about this have generated a general sense of relief throughout the EU.

However, the agreement was quite harshly assessed by leaders of some EU member states. French Prime Minister François Bayrou did not hide his disappointment about the agreement, calling the day of the agreement a “dark day” and describing the EU as being “submissive” to the United States. Similarly harsh were Hungarian Prime Minister Viktor Orbán, who said heavyweight negotiator Trump defeated featherweight negotiator Ursula von der Leyen, and Spanish Prime Minister Pedro Sánchez, who complained that – “I support the agreement, but I’m not enthusiastic about it”. Italian Prime Minister Giorgia Meloni (said to be among the European leaders who have good relationships with Trump) also reserved judgment, saying – “I’m thinking positively about the agreement, but I can’t make a judgment until I see the details.” More importantly, while acknowledging the agreement’s unequal nature, European Commission President von der Leyen herself put some positive spin on the agreement, saying – “15% should not be underestimated, but this was the best we could get”. If even the European Commission president felt free to note that the agreement was an unequal one, it is easy to imagine the dissatisfaction felt by leaders at the EU member state level.

It was inevitable that EU countries would be dissatisfied with the asymmetrical new agreement, which calls for a 15% tariff to be imposed on exports from the EU to the United States but no tariffs on exports of automobiles and other industrial products from the United States to the EU. (However, so-called “zero-for-zero” treatment (zero tariffs on U.S. exports to the EU as well as EU exports to the United States) will apply to such products as aircraft and aircraft parts, certain chemicals, generic pharmaceuticals and their ingredients, semiconductor manufacturing equipment, some agricultural products, natural resources, and critical raw materials, and von der Leyen noted that the EU would continue working to expand the scope of “zero-for-zero” treatment.) It is worth noting that, prior to the agreement, a flat 10% tariff was imposed on all automobile exports from the United States (or from other countries outside the EU) to the EU. The agreement calls for this tariff on U.S. auto exports to be abolished and for the tariff rate on EU automobile exports to the United States to be raised from 2.5% to 15%. These are quite clearly one-sided terms.

Moreover, as was the case with Japan, the EU is also being forced to make investment commitments. By 2028 (the final year of the Trump administration’s term) the EU has pledged to invest approximately USD600 billion in the United States and to purchase a total of USD750 billion worth of energy-related goods (natural gas, crude oil, nuclear-related products, etc.) from the United States. Given that the purchasing pledge is for a three-year period ending in 2028, one might imagine annual purchases should amount to around USD250 billion. The EU’s 2024 imports of energy-related goods (crude oil, natural gas, non-crude oil petroleum products, etc., indicated by dark bars in the graph on the previous page) from the United States amounted to only EUR76 billion, or approximately USD88 billion, however, so the new USD250 billion per year target appears to be clearly unrealistic. Given that and since the agreement appears to simply to leave purchases up to the discretion of EU-based companies on a voluntary basis, it may be reasonable to consider the USD750 billion energy goods



purchasing target to be merely a symbolic compromise commitment made to placate the Trump administration. In any case, however, the terms of the trade and investment agreement are clearly “asymmetric” in a literal sense.

Wise Decision or Craven Compromise?

So why did the EU go along with the agreement despite the symmetry or inequality of the agreement's terms? A clear hint about this was provided by European Commissioner for Trade and Economic Security Maroš Šefčovič, who said:

“It’s not only about the trade. It’s about security. It’s about Ukraine. It’s about current geopolitical volatility. I cannot go into all the details.”

While saying that it cannot reveal everything, the EU has stated that the trade agreement with the United States covers not only trade but also security issues, particularly geopolitical risk issues, including those associated with the Ukraine situation. This suggests that the EU made tariff-related concessions to obtain greater U.S. support for NATO and Ukraine. It bears keeping in mind that, if the United States were to withdraw from Europe completely, the EU would ultimately have to bear enormous additional security-related costs. Underway since the March 2025 EU summit, the ReArm Europe Plan has an estimated total cost of EUR800 billion, of which EUR650 billion is to be covered by increased government spending by EU countries (the remaining EUR150 billion is to be financed by EU joint bonds), so the plan will be pressuring EU countries to undertake expansionary fiscal spending programs. If the United States actually does reduce its presence in and commitment to Europe, the financial burden on EU member states can be expected to increase further.

Taking a broad view of the economic costs borne by its member countries, the EU likely feels that the latest trade deal with the United States was the best it could get, in the sense that, despite trade-related concessions, the agreement will still result in overall cost savings. Just as is the case with the Japan-U.S. agreement, there is no concrete written agreement, so there is a risk that the Trump administration may change its mind at some point and hike tariffs on European exports again, so there is clearly a potential for considerable dissatisfaction to be felt by the EU side going forward. The question of whether the EU's decision to go along with the latest EU-U.S. trade agreement was a wise decision or a craven compromise will depend on one's expectations regarding future events, and the accuracy of those expectations will not be completely clear until the end of the second Trump administration's four year term. At this point in time, however, it would be inappropriate to focus exclusively on tariff rates and trade and investment transactions values and confidently assert that the EU was out bargained in the trade negotiations with the United States based on those data alone.

Significance of U.S.-Russia Summit

Similarly, one should seek to understand the significance of the U.S.-Russia summit held in Alaska on August 15 in light of how it relates to a broad range of security-related issues. The summit's “no progress” result was widely expected, and the risk scenario of the United States unilaterally reaching a settlement with Russia without the involvement of Europe or Ukraine was avoided. After the summit, President Trump said – “There were many, many points that we agreed on, most of them I would say. A couple of big ones that we haven't quite gotten there, but we've made some headway. So there's no deal until there's a deal.” He did not disclose what the “many points” of agreement were, but I believe the summit's overall results reflect the success of EU diplomacy. As noted, the U.S.-EU tariff negotiations were concluded on terms clearly favorable to the United States, so there is a strong basis for arguing that those terms were granted by the EU in return for U.S. security-related commitments. My view is that the outcome of the U.S.-Russia summit needs to be understood in this context.

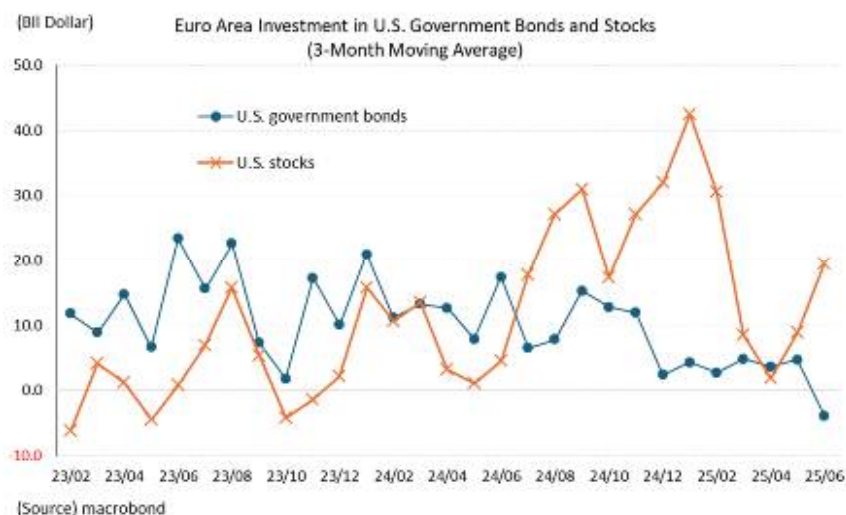
It seems fair to say the meeting went well for Russia. President Putin was presented with an ostentatious red carpet greeting and allowed to ride in the same car as President Trump, which many interpret as symbolically suggesting that Russia is not isolated internationally and has retained its status as an important player in international diplomacy. The fact that the summit was arranged without the participation of Europe suggested that while the United States and Europe may be close, they are not presenting a completely unified “Western” coalition. The meeting seemed to clearly demonstrate that Russia is not as internationally isolated as it was assumed to be when Russian banks were cut off from the SWIFT financial messaging system in March 2022.

EUR Now and Going Forward – Halt to ECB Interest Rate Cuts a Given?

Decline in U.S. Government Bond Investments

While it cannot be said with certainty that the U.S.-Russia summit was a material factor promoting EUR strength, it is true that EUR has been firm since the meeting, and an interpretation linking security factors to a EUR strength may be considered reasonably plausible in the long run. Previous editions of this article have repeatedly argued that, if it wants to maintain its global hegemonic power, the United States must invest additional resources in strategies and tactics for confronting China (an emerging hegemonic power), which will require a shift of resources away from Russia and thereby require Europe to shoulder a greater share of the burden of dealing with Russia. It is natural that this situation will decrease European confidence in U.S. security assurances. The United States is a hegemonic power precisely because it can exercise absolute power in terms of security, and it is because the United States is a hegemonic power that USD has been able to maintain its position as the world's principal reserve currency. It is thus only natural that the specter of the United States wavering between its desire to satisfy European and Russian needs will undermine confidence in USD as a reserve currency.

The U.S. Treasury Department's Treasury International Capital (TIC) data show that securities investment from the euro area to the United States remains strong regarding stocks but has noticeably dropped with respect to U.S. government bonds. On the other hand, the EU's balance of payments statistics show strong inbound securities investment from outside the EU, suggesting an unwinding of investment from the euro area to the United States as well as the possibility of new capital inflows from major economies into the euro area. However, since the TIC data is available only through June and the EU's latest balance of payments figures are for May, it is still unclear whether such changes will develop into a highly significant new trend. If these observed changes persist, they may eventually be reflected in the IMF's Currency Composition of Official Foreign Exchange Reserves (COFER) data. In any case, it appears that the "global capital rotation" and "European-US security relations" themes are likely to become strongly emphasized in the context of COFER data analysis.



Shakiness of Monetary-Policy-Based EUR Strength Scenario

Setting aside such long-term issues and focusing on key points regarding near-term monetary policy management, the picture becomes somewhat less clear. It might seem inevitable that EUR would strengthen against USD owing to the disparity between the ECB (which appears to have reached the end of its rate cuts) and the Fed (which is increasingly expected to implement further rate cuts), but the reality may be more complicated. Regarding inflation rates, for example, the euro area appears to have almost completed its convergence to 2% inflation rates, while U.S. inflation rates continue to show signs of rising upward from the roughly 2% level. If trends in such leading indicators as job



advertisement wages persist, the euro area consumer price index (HICP) growth rate may be depressed slightly from its current level, making it questionable whether the ECB will be able to halt its interest rate cuts before the HICP growth rate falls below 2% on a permanent basis (see graph). In contrast, given the possibility that tariffs may push up U.S. inflation rates, there remain doubts about the Fed's ability to continue its interest rate cuts. Even if the Fed does implement one or two rate cuts this year, it is unclear whether the new Fed chairman will be able to continue such cuts next year. The "global capital rotation" forex market theme appears likely to support EUR against USD over the long term, but EUR's prospective strength in the near term is less solid, being dependent on the more mundane "narrowing Europe-U.S. interest rate differential" theme.

Corporate Concerns Shift from Labor Shortages to Demand Shortages

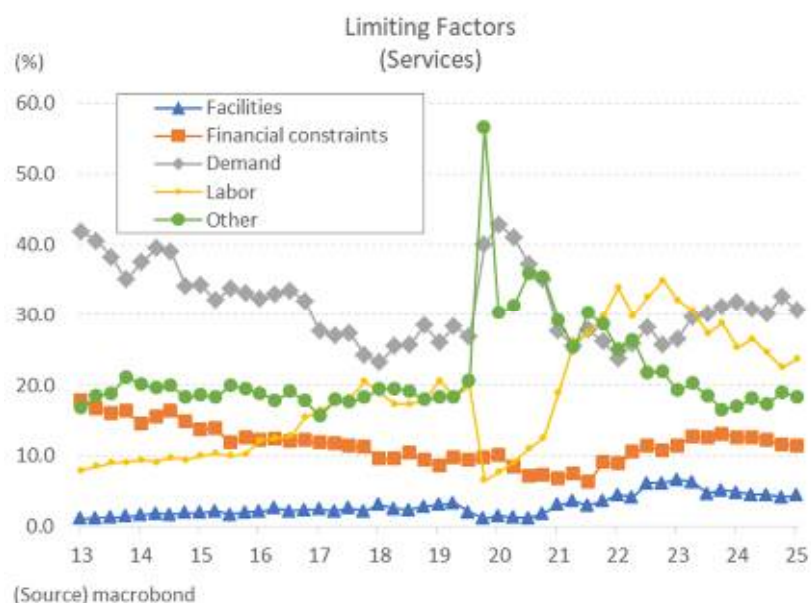
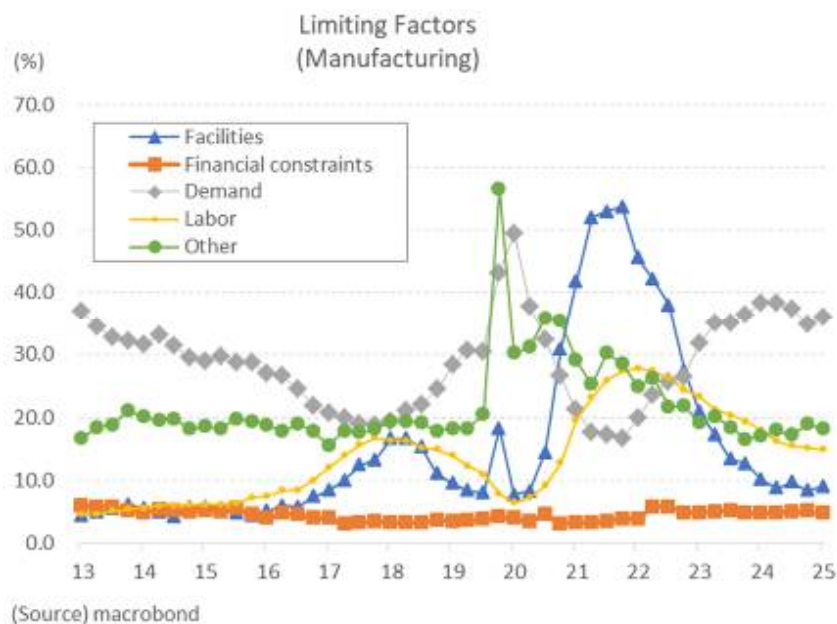
There was no ECB Governing Council meeting in August, and the previous “Fed rate interest rate cut considered certain, while ECB interest rate cut pause is assumed” situation has remained unchanged. At the time this article was written, financial markets were factoring in only around 0.8 of an ECB rate cut over the next 12 months. This reflects how the markets are taking previous ECB communications at face value, and I do not find it particularly surprising that market players are predicting that the ECB will implement one more rate cut at most. That said, the accuracy of current forecasts regarding the euro area’s real economy and associated inflation expectations remains to be seen. Given how dependent EUR/USD trends are on interest rate expectations (the anticipated Europe-U.S. interest rate gap narrowing), it becomes increasingly important to confirm how strong the euro area economy is and make sure the euro area inflation rate will not decline further.

The ECB has been cutting interest rates in response to deceleration in wage growth rates and in inflation rates, and that deceleration can be considered to reflect a trend of decline in domestic demand. However, there are now signs in such leading indicators as job advertisement wages that euro area wage growth rates may be beginning to bottom out. While there does seem to be a continued downtrend in negotiated wages for the time being, the leading indicators are giving a glimpse of the medium-term outlook. But one wonders whether there is really a basis for wages to bottom out. The European Commission’s quarterly survey of euro area businesses suggests that the biggest concern facing European companies in both manufacturing and services sectors has shifted from “labor shortages” to “demand shortages” (see graph). It now seems that the upward trend in nominal wages resulting from labor shortages is not likely to persist. The survey’s results indicate there has been clear progress in alleviating labor shortages over the past one to two years

but concerns about demand shortages remain high. This can be interpreted as suggesting that the ECB’s repeated interest rate cuts may not have contributed much to stimulating the euro area economy. (Or that the cuts may not have had an effect yet). Indeed, the HICP growth rate has stabilized at around 2%, but lack of prospective improvement in the “demand shortage” means that there remain downside risks regarding inflation. If inflation weakens and the economic situation evolves in a way that suggests a need for additional interest rate cuts, there will be cause for concern about a short-term downturn in EUR.

Important to Maintain both Short- and Long-Term Perspectives

I specify “short-term” in the previous sentence because the general “USD selling” forex market theme appears likely continue strengthening European currencies for the time being, making it difficult to imagine widespread EUR selling. There are emerging reports suggesting some uncertainties regarding the conditions for activating the U.S.-EU tariff agreement, and the more that distrust in U.S.-Europe economic and financial relationships grows, the more likely it will be that investment from Europe to the United States will stagnate. As discussed in previous editions of this article, this outlook is consistent with the current trend of decline in euro area investment in U.S. bond suggested by the TIC data mentioned above. It will be important for forex trend analysis purposes to determine the likelihood that this trend will continue. While EUR buying due to the narrowing Europe-U.S. interest rate differential may taper off in the short term, it will be important to also maintain a long-term perspective on how the “USD selling” theme is likely to maintain EUR’s resilience.



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